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C O N F I D E N T I A L SECTION 01 OF 05 BAKU 000408

SIPDIS

FOR EUR/CARC

E.O. 12958: DECL: 05/18/2019

TAGS: [AJ](#) [AM](#) [ECON](#) [EFIN](#) [EINT](#) [GG](#) [PINR](#)

SUBJECT: AZERBAIJAN: RESPONSE TO REQUEST FOR INFORMATION ON  
POLITICAL IMPLICATIONS OF GLOBAL FINANCIAL CRISIS IN  
CAUCASUS

REF: SECSTATE 41027

Classified By: Pol-Econ Chief Rob Garverick, reasons 1.4 (b) and (d)

1) (U) Post provides the following responses to ref  
questions on the political implications of the global  
financial crisis in the Caucasus.

2) (C) WHICH NATIONAL LEADERS AND/OR CABINET FIGURES ARE  
MOST ACTIVELY INVOLVED IN ECONOMIC DECISIONMAKING? ARE THERE  
DIFFERING OPINIONS WITHIN THE NATIONAL LEADERSHIP REGARDING  
APPROPRIATE ACTIONS IN LIGHT OF THE ECONOMIC CRISIS?

-- The key GOAJ ministers most actively involved in economic  
decision making are Finance Minister Samir Sharifov, Economic  
Development Minister Shahin Mustafayev and Central Bank  
Chairman Elman Rustamov. As in most decisions in Azerbaijan,  
President Ilham Aliyev is consulted prior to any decision and  
will issue directives often on very specific, even minute  
details. Differences in opinion among ministers and  
ministries exist, though public debate on policy differences  
is rare. Finance Minister Sharifov, who heads the  
U.S.-Azerbaijan Economic Partnership Commission, is  
considered by international observers to be competent and  
constructive, and is widely respected. Economic Minister  
Mustafayev, who replaced Heydar Babayev after the October  
2008 presidential election, has been less forthcoming with  
diplomats, and is generally seen as in the "bureaucratic"  
mode.

-- While no country is expected to completely escape the  
impact of the ongoing world economic crisis, the GOAJ  
unanimously believes that it is in a position to withstand  
the difficulties of the crisis relatively better than other  
countries, thanks to its solid foreign assets position and  
its still limited integration to the global financial system.

High export receipts and fiscal revenue for the last three  
years contributed to the strong foreign exchange and fiscal  
position of the country, which can be used to support demand  
if the domestic economic slow-down becomes more severe.  
However this assumes that expectations of devaluation,  
speculative for now, will not continue/accelerate; this is a  
difficult assumption to confirm at this time. So far this  
year the CBA and the State Oil Fund (SOFAZ) together have  
poured in over 3 billion manat to support the peg; Azerbaijan  
held about 18 billion manat in net reserves as of December  
[1](#)2008. (Note: current exchange rate is 1 USD = manat 0.82.)

-- Obviously the sustainability of this policy depends on the  
assumption that public expectations will stabilize and that  
massive net injections of cash into the financial system will  
not be required to protect the exchange rate throughout the  
year. (NOTE: SOFAZ is also slated to support the GOAJ budget

to the tune of 5 billion manat this year. End Note.) Additionally, ensuring efficient use of public finances, including strengthening the selection process for project funding, introducing cost and benefits analyses, and monitoring budget-financed projects, assumes even greater importance under these circumstances. Progress in improving the business environment will help domestic and foreign companies to maintain and expand their business activities and improve competitiveness, even in the face of an appreciating real effective exchange rate.

3) (C) WHAT ROLE DO OUTSIDE ADVISORS (FROM THE U.S. TREASURY, IMF, WORLD BANK, EBRD) HAVE IN SHAPING ECONOMIC POLICY? HOW DO NATIONAL LEADERS REGARD THEIR VIEWS?

-- The primary role of U.S. Treasury, IMF, World Bank and EBRD is purely consultative. The GOAJ meets with representatives from Embassy-Baku along with USAID, IMF, World Bank and EBRD on a regular basis.

-- The influence of IFIs, USAID and U.S. Treasury is further augmented by funded technical support programs. These organizations can influence policy somewhat through assistance programs, whether technical or financial. For example, the U.S. government, through USAID, is assisting the government of Azerbaijan in its financial regulatory oversight strategy formulation process, and establishing a Financial Investigative Unit in support of the new anti-money laundering law, by providing extensive interagency advisors. The U.S. DOJ was involved in the creation of the law from the beginning. Now, through interagency consultations, Embassy Baku expects to provide the GOAJ with advice from DOJ, FDIC

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experts, and the IRS to help formulate their anti-money laundering implementation and enforcement strategies.

-- Both the IMF and World Bank have a third means of influence; they issue reports to the international community covering economic issues in a particular country. The GOAJ places importance on their ranking in these and other such reports. As a result, the IMF and World Bank offer their advice on how to improve Azerbaijan's rankings, and this in turn may influence the GOAJ to make specific reforms. For example, the GOAJ improved a number of indicators on the World Bank's annual Doing Business Report and took great pride in stating that they were the World Bank's "Number One Reformer". Critics contend that the GOAJ analyzes how these rankings are determined and selectively chooses to work on &low hanging fruit<sup>8</sup>, areas where improvement can be made without seriously confronting endemic corruption in the country. In addition, the GOAJ has made USAID-supported advances critical to progress in the WTO accession process over the past two years, although there is still much room for improvement.

-- The Azerbaijani government believes that IFIs could perform a greater function in the global financial system. Finance Minister Sharifov noted the IMF's inability to adequately respond to or predict the recent global financial crisis, stating that "it simply follows events." The Minister is in favor of strengthening and recapitalizing the IMF and said that he believes it should be more proactive. Sharifov has noted on several occasions that his Russian counterpart, German Gref, has invited him and other CIS finance ministers to Moscow for consultations, most recently in advance of the G20 London Summit.

-- The Minister has also expounded on ways to improve the global financial system by expanding the role and authority of IFIs in general. He believes that they should have greater responsibility for supervision, as well as additional authority to monitor hedge funds and derivative transactions. Sharifov expressed interest in more regulations in general and greater interaction between national regulators at the highest levels. When asked to elaborate on his idea of a

"global financial board," he has explained that he was more concerned in creating an organization that would serve a more consultative function rather than as a guiding or regulating body.

4) (C) HOW DOES THE PUBLIC PERCEIVE THEIR COUNTRY'S ECONOMIC SITUATION COMPARED TO OTHERS IN REGION (OTHER CAUCASUS COUNTRIES, RUSSIA, UKRAINE, ETC)?

-- Generally speaking, the public seems to cautiously perceive that Azerbaijan's economic situation is somewhat better compared to others in the region (this is of course augmented by the GOAJ's public relations efforts in this area). Azerbaijanis are aware that the economies of Russia, Ukraine, Kazakhstan and Turkey have devalued their currencies, with impacts on inflation and otherwise. Azerbaijan's financial elite note that these countries have considerable exposure to foreign debt, while Azerbaijan does not. For example, Kazakhstan's high dollar denominated debt resulted in a demand by foreign banks to repay their debt early. This coupled with the devalued currency created financial sector adjustment problems in Kazakhstan. Fortunately for Azerbaijan, foreign debt peaked at only 2.5 billion USD (relatively low in relation to the size of the economy and the country's reserve position). Although some debt holders were asked to repay their debts early, this has had little impact on the economy, and notably less than in Kazakhstan. However, the loss in competitive positioning, augmented by a strong manat, has negatively impacted the non-oil export sector of the economy, and the GOAJ's projected real growth rates for the non-oil sector have been adjusted downward to about 5 percent. This is still higher than that of most transitional economy countries, but less than half of last year's growth. The number may also be bolstered by real estate and construction activity, particularly in Baku. The forecast assumes no further loss of confidence in the currency/financial system and no further drain on financial system liquidity.

-- Another reason the public perceives Azerbaijan's economic situation is better than its neighbors, is that the public has seen vast improvements in general living conditions over the last ten years or so. After the Nagorno-Karabakh war,

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the country was a disaster, with refugees crowding the cities and serious infrastructure deficiencies. In 2008, the GOAJ completed its relocation projects for refugees, moving them out of tent cities and encampments and into fully functioning settlements with infrastructure, schools, and support services. Oil revenues have begun to flow and the GOAJ has embarked on ambitious programs to rebuild or newly construct infrastructure, including roads and bridges, water and sewage, hospitals, schools, etc. Much work remains, but observers recognize that Azerbaijan began at a very low base.

5) (C) HOW DO LOCAL BANK OFFICIALS VIEW THE PERFORMANCE OF NATIONAL OFFICIALS IN HANDLING THE CURRENT FINANCIAL SITUATION? ARE BANK OFFICIALS LOBBYING THE CENTRAL BANKS TO TAKE CERTAIN ACTIONS--FOR EXAMPLE, RECAPITALIZING BANKS OR PURSUING FOREIGN EXCHANGE POLICY?

-- Most local bank officials believe that national officials have taken reasonable measures to handle the current financial situation. For example, since August 2008, the Central Bank reduced reserve requirements (the percentage of bank deposits that banks must set aside at the central bank) from 12 percent to one-half percent and lowered the discount rate from 15 percent to 3 percent. The Central Bank also provided liquidity to a few banks that were faced with temporary liquidity difficulties. (NOTE: There has been grumbling from some banks that access to the special liquidity fund established for this purpose is rationed out on an unequal discretionary basis. End Note.) Finally, the Central Bank signaled to banks that it is ready to continue to provide temporary loans to solvent banks faced with

short-term liquidity problems. In addition, the Ministry of Finance injected additional capital in the largest state owned bank, thus stabilizing for now its financial position, although not mandating any governance reforms as a quid-pro-quo. Furthermore, President Aliyev said the government may inject up to an additional 2.5 billion manat into local banks, although this could in fact be damaging from a longer-term financial stability perspective, particularly if rationed out on an unequal discretionary basis to politically-favored financial institutions. USAID and the major IFIs continue to speak proactively with the GOAJ and the CBA about the importance of ensuring appropriate design and formation of a sound incentive framework for any additional liquidity enhancement facilities, and to encourage the GOAJ to move towards full execution of the approved 2009 budget in order to stabilize aggregate demand and prevent further recessionary pressures.

6) (C) WHAT PRECAUTIONS, IF ANY, ARE BANKS TAKING IN LIGHT OF THE GLOBAL FINANCIAL CRISIS? SPECIFICALLY, ARE LOCAL BANKS TAKING ANY PRECAUTIONS REGARDING THEIR FOREIGN EXCHANGE EXPOSURE, OR ARE THEY PURSUING EXTERNAL FUNDING FROM WESTERN BANKING OR INTERNATIONAL LENDING INSTITUTIONS? FOR SUBSIDIARIES OF FOREIGN-OWNED BANKS, IS THERE CONCERN THAT FOREIGN BANKS WILL WITHDRAW SUPPORT FOR THESE SUBSIDIARIES?

-- Selected commercial banks have made moderate use of the CBA's liquidity enhancement facility. In addition, most banks have dramatically decelerated credit growth; furthermore, some are aggressively looking to expand their limited domestic deposit base in order to improve their liquidity situation. Most have little prospect at this point to access additional commercial international banking resources; although a number of banks have recently expanded IFI support programs designed to support SME/Microlending activities. Azerbaijan is flush with U.S. dollars, given strong revenues from oil exports. As of December 2008, the country's reserves stood at about 18 million manat.

7) (C) TO WHAT EXTENT ARE BANKS EXPRESSING CONCERN ABOUT CURRENCY DEPRECIATION?

-- Concerns regarding an imminent devaluation have been tempered, for now, because the GOAJ has assured Azerbaijan that this would not happen in the near term. It is expected that the GOAJ will reassess mid-year. A number of major banks are fearful about the potential impact of devaluation, given the significant asset/liability mismatch positions which they currently face (ie. high loan/deposit ratios, accompanied by major foreign debt exposure and significant foreign currency denominated loans which are backed by manat-based earning streams).

-- Finance Minister Sharifov and Central Bank Director

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Rustamov strongly advocate a policy of supporting the manat (currency) against depreciation/devaluation and have indicated repeatedly to EconOffs that the policy would not likely be changed any time soon; nonetheless, the Government and the Central Bank of Azerbaijan (CBA) are still awaiting the results of a USAID-supported stress test analysis of major banks in order to gain a fuller readout of the impact of a significant devaluation on the solvency/liquidity of the financial system. The GOAJ feels that keeping the currency stable favorably insulates the economy from the dramatic effects of the economic crisis evidenced in the surrounding countries.

-- GOAJ has also watched high inflation ensue in Russia and Armenia which they attribute to the currency devaluation. (Note: There has been significant real appreciation of the manat in relation to the currencies of major trading partners. As a result, non-oil exports have suffered significantly as a result of the GOAJ/CBA's determination to maintain a pegged exchangerate. End Note.) In addition,

the GOAJ is concerned that devaluation may worsen public expectations regarding the stability of the financial system and of the currency as a store of value. This could impact negatively on the financial position of major banks with significant asset/liability mismatch issues. As a result, the GOAJ remains committed to maintaining the currency as is, in an effort to protect it from inflation.

-- There is certain pressure, in fact, for the manat to continue appreciating. Oil contracts are denominated in U.S. dollars. Those dollars flow into Azerbaijan (oil exports now average about 1 million barrels per day). Some funds flow directly to the State Oil Fund (SOFAZ) and the State Oil Company (SOCAR) and may or may not be exchanged into manat. Other funds are converted to manat and distributed to the government budget. This conversion creates a demand for local currency and serves to put upward pressure on the manat.

8) (C) ARE INDIVIDUALS SWITCHING LOCAL CURRENCY BANK DEPOSITS INTO DOLLAR OR EURO-DENOMINATED ACCOUNTS?

-- Early in 2009, people seemed to be exchanging their manat for dollars or euros. This has reportedly stabilized over the past month, as people seem less concerned about a near term devaluation. (NOTE: We are still confirming this. End Note.) Because the Manat has remained stable, where other currencies, particularly the Euro, the Turkish Lira and the Russian Ruble, have fluctuated, Azerbaijanis expectations of a near-term devaluation appear to be dampening.

9) (C) ARE BUSINESS OWNERS CURRENTLY ABLE TO OBTAIN BANK LOANS? IF SO, AT WHAT TERMS?

-- The rate of credit expansion has decelerated massively over the past 6-8 months, and with the slight deflationary trend of the first quarter real rates on loans are now positive for the first time in a number of years. The major deceleration in credit availability underscores the severely constrained liquidity position in which most financial institutions find themselves at the moment, and is reflected in the GOAJ's dampened non-oil growth projections for the year.

10) (C) HAS THERE BEEN ANY RECENT CHANGE IN REMITTANCES FROM ABROAD? ARE WORKERS RETURNING FROM RUSSIA, EUROPE, AND OTHER COUNTRIES DUE TO LACK OF WORK?

-- Estimates of Azerbaijanis working abroad, almost entirely in Russia, range from 800,000 to two million. Because Russia's economy has been severely impacted by the financial crisis, Azerbaijani officials and residents fear that the economy will suffer a severe impact. It is estimated that currently remittances are down 33 percent, which disproportionately affects rural areas, rather than Baku.

11) (C) TO WHAT EXTENT ARE CONSTRUCTION PROJECTS BEING DELAYED AND/OR FROZEN PRIOR TO COMPLETION? WHAT IS CAUSING PROJECTS TO FALL SHORT OF COMPLETION?

-- Because of a slow down in the private construction industry, there has been a decrease in demand. For example a large steel company in Sumgayit failed and other construction supply companies are suffering.

-- Minister Sharifov has said that the construction projects

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in the pipeline would be completed. However, the GOAJ plans to carefully scrutinize any new projects. There was a time when almost all real estate projects received bank credit. At this point, the banks will stringently look at every project to determine which projects should be funded. That is to say, times have changed since last summer, when oil sold at \$140 per barrel. Overall the GOAJ has determined that it makes sense to fully execute the budget, assuming that the price of oil remains in the 50 USD/barrel range or

higher. There may be a reallocation of expenditures away from long-gestating projects and towards social expenditures and private sector re-activation programs which jumpstart spending and stimulate aggregate demand.

12) (C) HOW MUCH MONEY IS BEING TRANSFERRED FROM THE STATE OIL FUND BACK INTO THE BUDGET? HOW IS THE GOVERNMENT ACCOUNTING FOR THESE TRANSFERS IN THE GOVERNMENT BUDGET?

-- On 26 February 2009, President Ilham Aliyev approved the budget of the State Oil Fund (SOFAZ). During that meeting, Aliyev approved a 4.915 billion manat transfer from SOFAZ into the government budget. The government is accounting for these funds as a transfer into the state budget. However, so far the money transferred from the budget by SOFAZ has represented a net drain on reserves, since none of these resources has been repurchased by the CBA. Instead, the CBA itself funneled a large sum (greater than 1 billion manat) into currency markets during the first quarter to supplement SOFAZ foreign currency sales and stabilize the value of the manat.

13) (C) WHICH PARTS OF THE GOVERNMENT BUDGET, IF ANY, ARE OFFICIALS INDICATING WILL BE UNFUNDED IF OIL PRICES REMAIN BELOW THE \$65/BARREL BASELINE USED IN WRITING THE BUDGET? HOW HAVE OFFICIALS INDICATED DEFENSE SPENDING SPECIFICALLY WILL SUFFER, IF AT ALL?

-- As for the 2009 budget, the current lower-than-budgeted world market oil prices will not create a substantial problem, assuming that the price of oil remains in the \$50/barrel range during the course of the year. The amount of the transfer is fixed in manat terms (4.915 billion) and SOFAZ has sufficient resources and revenues that will enable it to make the transfer and continue to maintain a solid asset position (again assuming no further worsening of market expectations regarding the stability of the currency and/or the financial system). However, given that the revenues from SOCAR and non-oil related tax collection might be lower than previously envisaged because of lower world oil prices and decelerating non-oil growth, and the costs related to some budget expenditures that have high import content may also be lower than budgeted, the government will undertake a reassessment of the budget mid-year. As of April 2009, it was estimated that SOFAZ and the Central Bank had approximately 16 billion in reserves (down from 18 billion manat in December 2008). Thus, the economic crisis has had a moderate impact on the country's reserve position.

-- According to a Locally Employed Staff member who previously worked at the Ministry of Economic Development, the GOAJ is emphasizing internally that their projections will not be significantly negatively impacted until the price of oil drops below \$40/barrel (the point at which the current account would become negative).

-- The GOAJ has no plans at this point to decrease defense spending during the course of the fiscal year. If anything, the budget will increase, as there has been some discussion of supplemental spending.

14) (C) WHAT PLANS, IF ANY, DOES THE GOVERNMENT HAVE TO BUY UP UNFINISHED OR UNPROFITABLE REAL ESTATE PROPERTIES IN BAKU? ARE CONSTRUCTION/REAL ESTATE BUSINESSES LOBBYING FOR SUCH A MOVE?

-- To date, the government has not announced any plans to buy up unfinished or unprofitable real estate properties in Baku. There are no indications that construction companies are pressing for such an agenda or that the government would be willing to consider such action. Around Baku, construction work is continuing at existing sites; there does appear to be a slow down in new construction works.

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